AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

Second Quarter **July 2020**

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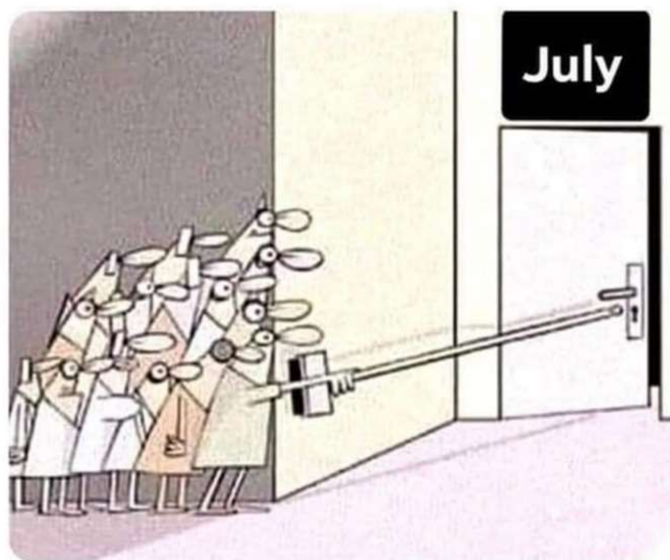
Stock markets staged a strong rebound in the second quarter. The S&P 500 Index returned +20.5%, bringing its year-to-date tally to -3.1%. The Dow Jones Industrial Average has fallen -8.4% year-to-date while the Russell 2000 Index has fallen -13.0%. Foreign developed stocks returned +15.2% and emerging stocks +18.1% in the quarter, bringing their year-to-date totals to -11.0% and -9.7%, respectively.[1] Bonds returned +0.6%, bringing their year-to-date return to +5.8%, reflecting a drop in interest rates (bond prices rise when interest rates fall).[2]

In early January reports started to surface that people in China were being sickened by an unknown form of pneumonia. It is hard to believe where we are six months later. Over twelve million people worldwide have been diagnosed with Covid-19 (many more have likely have had it) and over half a million have sadly passed away. As if that wasn't enough to worry about, American cities were gripped by riots, U.S. and China relations continued to fray, and OPEC+ – the group of countries that work together in an effort to control oil prices – briefly fell apart. Fear gripped the stock market and the S&P 500 fell -35% in just one month – the quickest drop of that magnitude ever. On March 23rd, the S&P 500 was down -30% for the year. Many believed it could fall further given the risks facing society and the global economy.

Yet by June 8th the S&P 500 had gotten back to even for the year. Through quarter-end the S&P 500 gave up some ground but still finished the first half of the year down just -3% from year-end. We often tell our clients that it is impossible to time the market and 2020 serves as a prime exhibit. Who would have predicted on December 31st, 2019 that the stock market would be down just -3% through the first half of the year in light of everything that has transpired? While it remains a confusing and volatile world, we do our best below to walk through the questions that have been on our minds and those of our clients. We apologize for the length of this quarter's commentary, but it is a crazy time!



[1] As measured by the relevant MSCI international indices.
[2] As measured by the Citigroup 1-10 Year Government Bond index.

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How can the stock market only be down -3% this year given everything that has happened in the world?
Clients often ask us if they should get out of the stock market because of one concerning risk or another. But it is always important to remember the following: If the risk you are worried about is widely known by other investors, there is a good chance it is already "priced" into the stock market. This isn't always true, but we should be respectful of what the stock market already knows. For instance, if you were sure in early January that the strange pneumonia that had begun circulating in China would engulf the globe, infect millions of people and shutdown economies, then you might have been able to predict that stock prices would fall. But in March, everyone knew about the virus, as they did in June. At that point, whatever you are worried about is probably already reflected in stock prices.

In mid-March, there were a lot of unknowns about the virus and its economic impacts. How deadly was Covid-19? Could we successfully develop effective therapeutics or a vaccine? If so, when would they be ready? Would lockdowns halt the spread of the virus? Would companies be able to get the financing they needed in order to survive the crisis?

Stock prices fell materially, reflecting the immense uncertainty of the moment. Yet many investors still argued that stock prices weren't that cheap, especially relative to how cheap they have gotten during past crises (such as the 2008-09 financial crisis).

Then stocks staged a quick and dramatic comeback. Did this simply reflect stock prices that were too low in March? Were investors behaving irrationally at the bottom? There were a few days in March that felt like true panic selling, but that subsided quickly – the S&P 500 rebounded over +17% in just three days in late March. Beyond that, a lot of the rebound has reflected greater clarity on the above questions.

First, the Federal Reserve and the Federal Government stepped up to support the markets and the economy in truly unprecedented ways and with unprecedented speed. The Federal Reserve expanded its balance sheet by nearly *$3 trillion* – this means they effectively printed $3 trillion and injected it into the financial markets.[3] That's a lot of money! And they didn't just buy government bonds, but also corporate bonds and even so-called "junk" bonds – bonds of riskier, more levered companies. This was unprecedented and some market observers believe even illegal.[4] Regardless, the Fed sent a clear message to Wall Street: We will support companies and give them the liquidity they need to make it through this unprecedented crisis. The Federal Government also stepped in with its own $2 trillion stimulus package.[5] This all added up to a lot of money getting injected into the economy, and a lot of that money seemingly found its way into the financial markets, supporting not just bond prices but also stock prices.

It can be hard to wrap one's arms around such big numbers, so let's try to put the stimulus efforts into perspective. Between the Federal Reserve and the Federal Government, roughly $5 trillion was injected into the economy. Gross Domestic Product (GDP) in the U.S. was $21 trillion in 2019, so the Federal authorities injected reserves and payments equal to nearly one-quarter of the country's annual economic output. With roughly 330 million individuals in the U.S., that represents over $15,000 for every man, woman and child in the country.

In addition – and thankfully – some of the worst fears about the virus were taken off the table. While still dangerous, it is not quite as deadly as some early estimates. And while there is a long way to go on the treatment front, there has been positive news regarding potential therapeutics and growing optimism about a vaccine that could come as early as year-end or early 2021. Lockdowns seemed to work and case counts initially appeared headed in the right direction, leading most investors to look past summer and towards a potential second wave of illness in the fall when we might be better prepared.

Economic activity rebounded sharply from truly depressed levels, with much better than expected jobs numbers and retail sales data. Investors started to be hopeful about the possibility of a V-shaped recovery (as opposed to a U, a W or an L), although the ultimate outcome remains uncertain. Investors also started to forecast lower interest rates for longer, making stocks comparatively attractive (more on that later).

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[3] Federal Reserve website ("Recent balance sheet trends").
[4] Section 13(3) of the Federal Reserve Act requires the Fed to take collateral when it lends to corporations such that the collateral is "sufficient to protect taxpayers from losses." The Fed got around this by leveraging the money appropriated to it by the U.S. Treasury and treating the original funds as the collateral.
[5] The CARES Act was estimated to include $2 trillion in federal stimulus payments and loans to American individuals and businesses.

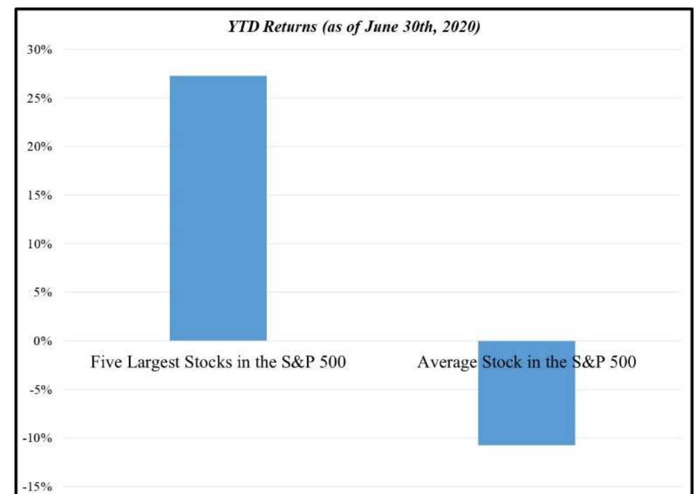
It is also important to note that the stock market has become increasingly dominated by a handful of large technology companies. In fact, the five largest companies in the U.S. today – Microsoft, Amazon, Apple, Google and Facebook – now account for over one-fifth of the total stock market, a historically large portion (see graph to the right).

Investors see these companies as beneficiaries of the pandemic and pushed their stock prices higher. Unfortunately, many mom-and-pop type businesses which aren't as well represented in the stock market have been under much greater distress. Small-cap value stocks, perhaps a better corollary for local businesses, are down -23% year-to-date.[6] Indeed, the "average" stock in the stock market has underperformed the aggregate stock market by a historic margin this year, reflecting the outperformance of the largest companies. The chart at the bottom right shows the performance difference between the largest five stocks in the S&P 500 and the average stock in the S&P 500.[7]

Stock prices started to come under some mild pressure again in mid-June as case counts in certain parts of the U.S. began to rise dramatically, threatening hopes of a summer lull. Unfortunately, America has had a tougher time than many other countries getting control of the virus. Consider the fact that while 97% of Apple's international stores are open, only 66% of their U.S. stores are open.[8] Yet stock prices have nonetheless remained relatively resilient, likely reflecting a lack of attractive alternatives in other investment areas and confidence that we will be able to figure this out and the economy can rebound.

Are stock prices too high? Should I sell my stocks?

The rebound in stock prices leaves some investors asking: Are stock prices too high? Should I get out of the stock market? First, we want to highlight that there clearly remain near-term risks to the economic outlook. Obviously the virus continues to weigh on the economy and a return to normal is dependent on getting the virus under control. Other risks include further deteriorations in U.S.-China relations and the potential for higher corporate tax rates post-election, among others. We expect stock prices to remain volatile over the next year, meaning there may be a lot of ups and downs.



That being said, we think it is a misleading to imagine that there is a "right" price for the stock market. Pundits often throw out a "price target" for the S&P 500, implying that anything above that target is too high and anything below that target is too low. But as we have argued time and time again, stocks are not priced in a vacuum. If an investor thinks stock prices are too high, that implies that he should sell his stocks and invest the money elsewhere. But where else is he going to put the money right now? Bank accounts are back to paying nothing. A 10-year U.S. Treasury bond currently pays just above 0.6%. The country of Austria has a 100-year bond that pays just 0.65% per year![9] As a result, investors are willing to pay higher prices for stocks than they otherwise would simply because of TINA – "there is no alternative." This may have

[6] As measured by the Russell 2000 Value Index through June 30th, 2020.

[7] Performance for the five largest stocks represents the weighted average return, while the return on the average stock is calculated using the return on the S&P 500 Equal Weight Index.

[8] "The vast majority of Apple stores closed due to the Covid-19 pandemic are located in the U.S., Morgan Stanley says," by Kif Leswing of CNBC, July 8th, 2020.

[9] As of July 10th, 2020, per Bloomberg Finance.

been part of the Federal Reserve's motivation to flood the market with liquidity – i.e. drive up stock prices in order to support investor confidence which may create a positive feedback loop to the real economy.

Now this doesn't mean that stock prices will stay high. For instance, if inflation takes off and interest rates go up, the calculus changes. If we woke up tomorrow and we could buy a 10-Year U.S. Treasury bond that paid 10% per year instead of 0.6% per year, we'd be inclined to sell stocks and buy Treasuries. We would be attracted to that safe 10% return. But if everyone tried to sell their stocks, stock prices would fall.

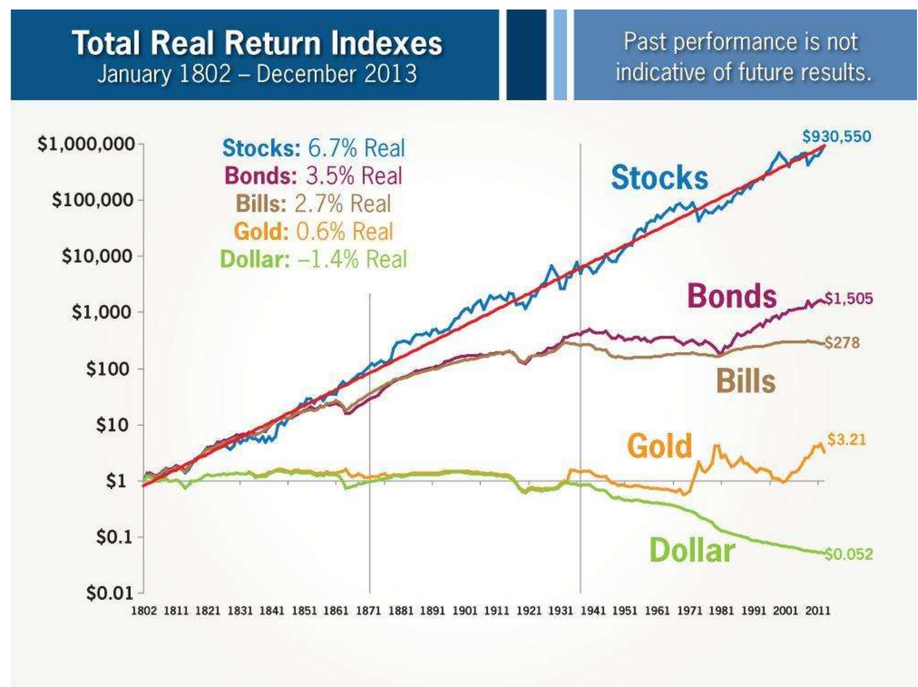
Yet while all this money-printing from the Fed could threaten inflation at some future date, it also seems possible that we remain stuck in a lower-growth, lower-inflation, lower-interest rate world for an extended period of time (as we have the past decade). In other words, there is a good chance we don't see anything close to 10% yields on U.S. Treasuries for a long time.

If we felt confident that we could earn more attractive returns elsewhere – bonds, real estate, etc. – we might be able to say that stock prices are too high. But that clearly isn't the case now. This DOES NOT mean that stock prices can't fall materially from current levels. They can, especially if the economy fails to rebound or interest rates rise. It just means that stocks still offer the opportunity to earn higher returns than the alternatives, even though the outcome isn't guaranteed, especially over the near-term.

At the end of the day, the investor's time horizon really matters. We recommend that clients not invest new money they may need in the next two to three years in stocks. But longer-term, we retain our belief that stocks will be worth more ten years from now. If you own a diversified portfolio of stocks, you have an ownership interest in many great long-term assets – things like railroads, utilities, real estate, etc. Many of these assets have dividend yields well above what you can earn from bonds. Ten and twenty years from now, we believe these assets will produce more cash flow than they do today and their stock prices will be higher. We think returns on stocks will outpace the alternatives such as a 10-year Treasury bond that pays 0.6% per year. But we can't predict what might happen over the next six or twelve months and we can't offer any guarantees.

Should I own gold?
We believe there are respected investors on both sides of this debate. One side argues that gold produces no cash flow and pays no dividends (it actually costs money to store), and it is therefore impossible to value and inferior to investing in strong, dividend-paying companies. The other side argues that the world is uncertain/risky and investing a portion of your portfolio in gold is a good way to hedge extreme downside risks.

We aren't certain who is right, but we don't own any gold in our portfolios and don't plan to purchase any. That isn't to say gold won't do well, but like the skeptics outlined above, we would much rather invest in high-quality, dividend-paying companies. Over the long-term this has clearly been the superior strategy. The chart to the right shows the real return (i.e. the return after adjusting for inflation) for stocks, bonds, gold and cash. As you can see, gold hasn't come close to matching the returns on bonds, let alone stocks, longer-term.



What will be the result of the massive amount of money printing and borrowing by the Federal Reserve and Federal Government?
We wish we knew the answer to this. We had concerns about the fiscal situation prior to the pandemic, which only exacerbated the problem. The CARES act cost $2 trillion, or more than $6,000 for every man, woman and child in the country. The U.S. government's budget deficit in June nearly equaled its deficit for the entire 2019 fiscal year,[10] and states and municipalities are under even more strain. The Federal Reserve had been hoping to reduce the size of their balance sheet in the coming years, which remains bloated from the extreme actions taken during and after the 2008-09 financial crisis. Now they've increased it again by $3 trillion and counting.

We are in unprecedented territory, so we are hesitant to make any bold predictions. The corporate tax cuts enacted a few years ago could be at least partially reversed after the election, pressuring corporate earnings. All of the extra money inserted into the economy could create inflation, especially if international trade starts to regress. On the other hand, pundits have been predicting inflation since the last financial crisis and we've had the opposite – the Federal Reserve has remained concerned that inflation has been running *too low*.[11]

Even if we knew inflation was coming, we'd still want to own the stocks of well-capitalized, high-quality companies which should do better than cash or bonds in such an environment. But as Warren Buffett recently opined:

> We're doing things that we really don't know the ultimate outcome [to] and I think in general [they] are the right things, but I don't think they're without consequences and I think they could be kind of extreme consequences…but there would be kind of extreme consequences if we didn't do it as well.[12]

In other words, damned if you do and damned if you don't.

To what extent will business and consumer habits change?
This has been perhaps the most vexing question for us. We have remained steadfast in our optimism that with so much firepower aimed at the virus, the world will find a solution and it will likely find it sooner rather than later. We are all anxious to get back to "normal" life. But it is more difficult to predict how business and consumer habits may permanently change once we start to return to normal.

Financial crises seem to occur every five to ten years, and while they are difficult to predict in advance, they are often built around severe excesses that have amassed in some corner of the market. The 2008-09 financial crisis grew out of reckless behavior in subprime mortgages; the dot-com crash grew out of the technology bubble; and so on.[13]

The global pandemic has risked morphing into today's economic and financial crisis. But unlike other crises, this one had nothing to do with excesses in a certain part of the market or irresponsible behavior on the part of corporate executives or investors.[14] Instead, an unforeseen virus has caused countries to shutdown large parts of their economy and consumers to shelter-in-place in the hopes of avoiding infection. This has had a drastically different impact on different industries.

Businesses that require human interaction in order to facilitate commerce have been under immense strain through no fault of their own. Meanwhile companies that help facilitate commerce in the absence of human contact have benefitted. This has had the effect of favoring large technology companies and hurting many smaller companies, even if those smaller companies were fine businesses with good management teams and healthy balance sheets. Even within single industries, some have benefitted while others have not. For instance, retailers deemed "essential" have experienced strong sales

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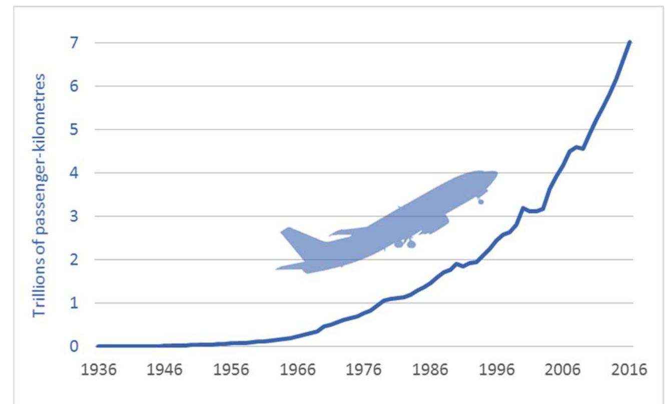
[10] "The vast majority of Apple stores closed due to the Covid-19 pandemic are located in the U.S., Morgan Stanley says," by Kate Davidson in *The Wall Street Journal*, July 8th, 2020.
[11] Economists worry about a so-called deflationary spiral, where consumers start to defer purchases because of an expectation of lower future prices, which reduces prices further, causing more deferrals, etc.
[12] Berkshire Hathaway Annual Meeting, May 3rd, 2020.
[13] The Asian Financial Crisis of the late 1990's grew out of an excess of foreign denominated debt and the S&L crisis of the late 1980's grew out of excess in the junk bond market.
[14] Although there is an argument that as a whole, both corporate America and government authorities were overlevered and therefore insufficiently prepared for a storm, no matter the source.

while other retailers deemed "non-essential" were forced to shut down their locations and sacrifice most or all of their revenue. Companies have fought for the right to be deemed "essential" by government entities so they could keep operating during the shutdowns. CNBC's Jim Cramer put it well:

> If you make technology that helps businesses cut costs, especially by firing people, you're doing fine. If you make something that people literally can't live without, like medicine, you're in good shape. But just about everything else is struggling here.[15]



From an economic perspective, it feels like an unexpected bomb went off in the economy but only hit certain industries. Impacted industries are under immense short-term pressure, while the industries that weren't hit are benefitting at the expense of the industries that were hit. And there was no time to take cover – the bomb came quickly and unexpectedly. Investors in impacted industries went to bed one night feeling good about what they owned and woke up the next morning to find wreckage.

As a result, we've had a bifurcation in the stock market. Technology and biotech/pharmaceutical stocks have rebounded sharply, while industries close to the crisis and the sectors that service those industries have continued to struggle. For instance, anything related to travel, tourism and retail have been hit hard, from airlines to hotels to restaurants. Companies that service these sectors – think plane manufacturers and their suppliers – have also come under pressure.

Now if the virus is just a "time-out" for a short period of time while we learn to defeat it and then businesses and consumers return relatively quickly to their pre-virus habits, then the stock prices of these impacted companies have likely fallen too far and the consensus opinion is too dire. But how quickly will things go back to "normal"? Will business people travel as much as they used to? Will businesses have employees continue to work from home and shrink their office footprints? Will consumers snap back to old travel habits? How many people will return to pre-virus shopping habits?

We have opinions about these issues, but it is hard to predict how things might play out. Predictions of large changes in behavior as a result of some exogenous event often go too far. For instance, many people thought 9/11 would permanently reduce the demand for air travel, but businesses and consumers returned to the air relatively quickly once they felt safe (see graph at the top right). On the other hand, the current crisis is unique and today's technology solutions have allowed businesses and consumers to operate surprisingly well under stay-at-home orders.

With uncertainty surrounding these industries, we think it is imperative to own the "best-in-class" companies within effected sectors. The 2008-09 financial crisis hit the banking industry hard and, in the thick of it, it seemed like no bank would be spared. But in hindsight, the strongest banks got stronger and the weaker banks got weaker. Those banks that had the capital and operational capability to steer through the crisis relatively unscathed were much better prepared for the recovery, taking share from their competitors for years. We think it is possible the same could happen in today's effected industries. Although their end markets may be impacted for some time, it is also possible that the strong get stronger while the weak get weaker. But it is hard to predict how the world might play out. If you have any comments, questions or concerns, please don't hesitate to contact us. As always, we thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
Ryan A. Kay, CFP®, AIF®

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[15] "Jim Cramer on Wall Street trading trends: 'This action makes little sense'," by Tyler Clifford of CNBC, May 6th, 2020.

Get to Know AMI: Ryan Does TBT and AMI's 2020 Summer Interns

AMI's own Ryan Kay served as the founding General Manager for the "Men of Mackey," a team comprised mostly of Purdue basketball alum that recently competed in "The Basketball Tournament," or "TBT." TBT is a winner-take-all competitive basketball tournament aired on ESPN that includes a $2 million pot. Most players in the tournament play professionally and teams are usually organized around a leading college basketball program, including Ohio State, Marquette, and Syracuse. Ryan is a member of the Board of Directors for the Purdue Alumni Association and hatched the plan to start a Purdue-oriented TBT with several recent Purdue basketball alums. The Men of Mackey included recent Purdue players Isaac Haas, Evan Boudreaux and Jonathan Octeus, among others. The tournament was materially modified this year in light of Covid-19 and Ryan and the team travelled to Columbus in early July for the single-elimination contest. The Purdue team had a great run, including a come-from-behind upset over a higher-ranked Baylor/Michigan State team and a close loss to a tough Syracuse team. Ryan is looking forward to making another run at the trophy in 2021.

AMI is continuing our support of budding investment professionals by hosting two summer interns this year. Ben Axel (bottom left) will be a sophomore at Wabash College this fall and is majoring in Philosophy, Political Science and Economics as well as playing on the school's baseball team. Ben Elliott (bottom right) will be a sophomore at Harvard University this fall and is majoring in Economics. Both graduated from Canterbury High School. We are thrilled to have them join us for the summer and they've been a great help with internal research projects and office tasks.

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